TAXATION PROPOSALS

Respecting The

CANADIAN OIL AND GAS INDUSTRY

ALBERTA DEPARTMENT OF ENERGY
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TAXATION PROPOSALS RESPECTING THE CANADIAN OIL AND GAS INDUSTRY

Executive Summary

The crude oil price collapse which occurred in early 1986 has had a severe negative impact on the oil and gas industry. While many positive policy changes have occurred respecting the oil and gas industry in the last couple of years, the industry does not have the investment incentives it had prior to 1981. In particular, the disappearance of PIP/APIP without a replacement, has exacerbated the current financial difficulties of the industry.

In response to these difficult financial circumstances, and lack of investment incentives, the Government of Alberta introduced a variety of assistance measures including reductions in royalty levels. It is apparent that further incentives are required, especially to assist in attracting new equity to the industry.

Alberta Recommendations

The major recommendations of the Government of Alberta are:

(1) Earned depletion on all new Canadian exploration expense (CEE) and new Canadian development expense (CDE) be reinstated, with no restrictions on the extent to which or the type of income against which it can be written-off. This will:
- o provide a basis for raising new equity for the industry by means of flow-through shares;
- o have a direct and positive impact on industry cash flow and project economics;
- o treat the oil and gas industry on an equitable basis compared to the mining industry.
- o provide a replacement for PIP/APIP.

(2) Provincial incentives to the oil and gas industry be exempt from taxation;

Other Recommendations

(3) It is recommended that flexibility be built into the Income Tax Act to allow Revenue Canada to relax the rules requiring separate streaming of income and expenses from preceding corporations within a successor corporation. Relaxation of these rules would only apply where such action is a component of a package of measures to revitalize specific companies through merger or acquisition. This change is requested to make more effective the activities of the Small Producers Assistance Commission.

The following tax changes have been put forward by various parties as being beneficial to the oil and gas industry. While supportive of these changes Alberta does not see them as critical as the first two proposals.

(4) Allow Canadian oil and gas property expense (COGPE) to be depreciated on either a 30% declining balance or 20% straight line basis; and

(5) Allow the Canadian exploration expense (CEE) to be discretionary, like other income tax deductions.

I. THE IMPACT OF THE PRICE COLLAPSE ON THE OIL AND GAS INDUSTRY

The crude oil price collapse which occurred in early 1986 has had a devastating impact on the financial health of the industry. The extent of this impact is partially revealed by the recent report from the Petroleum Monitoring Agency (PMA) on their Survey for the first six months of 1986. This survey shows upstream total revenues to be down 34%, net earnings to be down by 56% and net cashflow to be down by 38%, compared to the first six months of 1985. These PMA results are only partially indicative of the impact of price collapse on the industry, because:

i) the price collapse did not commence until later in January, 1986 and then occurred somewhat gradually over the remainder of the first quarter, and
ii) the comparable period for 1985 includes five months during which Canadian crude oil prices were still regulated, with a large portion of Canadian crude oil production selling at prices well below market levels.

Figure 1
Preliminary Impact of Price Colla
Upstream Operations

Source: PMA

The PMA reported that upstream capital expenditures declined by only 7.5% during this interval. This is reflective of the high level of capital spending in the first quarter of 1986, which occurred as a result of:

i) the fact that capital budgets were made prior to the price collapse, and that such spending plans are not immediately responsive to changes in the economic climate, and

ii) the expiry of PIP/APIP on March 31, 1986, which provided an incentive to complete as large a portion of 1986 planned investment as possible within the first quarter.

More generally, investment in the oil and gas industry follows industry cash availability very closely, as this investment is typically funded from internal sources. This is especially true of exploration spending, because of the risk associated with this type of investment.

Thus, the PMA results respecting earnings and cashflow should be viewed as conservative estimates of impact, and the PMA results respecting investment should be viewed as anomalous, because full adjustment had not occurred over the reporting interval.

While the corporate viability of many companies is at stake, the focus of this paper is the impact of the industry financial situation on oil and gas investment. The oil and gas industry is very capital intensive. Industry activity, employment and the ability to maintain production are all highly dependent on investment. Not only is such investment important to the energy industry, it is very important to the Canadian economy. The recent PMA report stated that upstream petroleum investment constituted 27% of total Canadian non-financial investment in 1985. The upstream petroleum industry is considerably more important in the regional economies of the petroleum production/exploration regions of Canada.

The low and declining levels of oil and gas investment in Canada do not reflect an absence of attractive oil and gas investment opportunities. Such opportunities exist and have been expanded considerably through provincial initiatives. Alberta has enlarged its minimum one year, depth related, holiday on new crude oil production to five years. The low level of investment occurring in the oil and gas industry is in large measure a consequence of the lack of funds to undertake such activity. The industry is cashflow constrained, more than it is opportunity constrained. Section V-A provides some details.

The next section of this paper will address the funding constraint in greater detail. Some of the consequences of this curtailed level of investment will then be outlined. Finally, some recommendations for stimulating incremental investment will be proffered.

II. TRADITIONAL SOURCES OF FUNDS

A. Internal Cashflow

Industry cashflow has traditionally been the most common source of funding for a very large portion of oil and gas investments. Internal cash available for investment has been substantially reduced as a consequence of the price collapse. As noted previously, the PMA results provided a conservative estimate of this reduction.

The industry has made efforts to improve its cash position. To the extent that these efforts have improved efficiency, they are clearly laudable and will ultimately result in a stronger industry. To the extent that the measures are simply to conserve cash because the companies cannot afford to adequately maintain its operations, what appear to be "rationalization" efforts are merely symptoms of the problem rather than solutions. Based on the plethora of aggregate statistics on lay-offs and cutbacks, it may be difficult to distinguish between efforts which improve efficiency and those which result in deterioration. One thing which is clear is that industry efforts in total will be inadequate to generate internal cash to fund a reasonable level of investment.

Governments have contributed significantly during 1986 towards improving industry's cash position. Alberta has implemented royalty reductions, enhancements to its Royalty Tax Credit, as well as other incentives and holidays. The federal government has finally eliminated its discriminatory PGRT. Further tax measures that restore equity to the petroleum industry relative to the mining industry and which will help restore an acceptable level of industry activity are required.

B. External Funding: Debt

It must be recognized that concomitant with the price collapse has been an asset value collapse for oil and gas companies. Thus, companies that were highly debt-levered before the price collapse are in especially difficult circumstances today (indeed, their viability may be threatened). The consequence of lower asset values and diminished capability to service and repay debt is a severe curtailment of debt financing opportunities. Lending institutions, being cautious by nature, are more likely seeking to extricate themselves from existing loans to the oil and gas industry, than to be extending new loans.

C. External Funding: Equity

Opportunities for traditional equity generation are also limited under current circumstances. There is, not unexpectedly, reluctance on the part of companies to issue new equity when the value of their shares is at a very low level. More significantly, there is reason to doubt that a sufficient number of potential new investors would come forward under the current tax regime to allow new equity to be marketed successfully.

III. BROADER CONSEQUENCES OF THIS SITUATION

With industry having taken economizing measures, with governments having responded to some considerable extent, with external financing opportunities ranging from unattractive to unavailable, no dramatic improvements in the financial situation of the oil and gas industry are expected in the short-term. This prognosis leaves some very undesirable consequences for the Canadian economy, which will be outlined below.

A. Economic Activity

Economic activity in the oil and gas sector can be expected to remain at low levels compared to traditional levels. This reduced level of activity can be expected even with the availability of generous incentives, such as Alberta's five year crude oil royalty holiday.

This decline in activity (i.e. investment spending) has had, and will continue to have a negative impact on the Canadian economy. Petroleum investment has always been viewed as an engine of growth in the Canadian economy, constituting 27% of total non-financial investment. Spin-offs extend the impact of this investment beyond the petroleum producing regions of Canada, to the centres of manufacturing as well. In the past, there has been some controversy as to whether low energy prices (and concurrent low energy investment) contribute more to the Canadian economy than high prices (and high energy investment). Much of this controversy can be resolved by looking at Canada's economic performance relative to other developed economies for the decade prior to 1985 when Canada had artificially low energy prices. Despite a massive subsidy of over $50 billion at the expense of Alberta producers and the Government of Alberta, the Canadian economy did not perform noticeably better than industrial countries that were faced with immediate and full adjustment to higher prices.

There is no potential for controversy regarding the adverse impact of low energy activity in the producing regions of the country. The severity of the economic impact is most evident in Alberta, where oil and gas production constituted some 28% of the value of provincial production (GPP) in 1985. A survey conducted for the Governments of Alberta and Canada earlier in 1986 showed that direct job losses in Alberta alone in the oil and gas sector will total 25,000. More significantly this has occurred at a time when the Canadian unemployment rate has been falling.

While the regional impact of this situation is greatest in Alberta, it is also significant in British Columbia and Saskatchewan and parts of the Northwest Territories and Atlantic Canada. It is important to note that a robust petroleum industry provides a broad economic stimulus to other sectors of the economy and regions of the country.

B. Security of Supply

Low oil and gas activity results in many short-term economic problems. In the long-term we jeopardize our security of supply. The security of supply implications were demonstrated by Alberta Energy to the Provincial Ministers of Energy in September, 1986 and more recently in the NEB Report on Canadian Energy Supply and Demand: 1985 - 2005.

Long-term crude oil security depends not only on maintaining some level of activity in conventional producing areas, but also ensuring that some major projects proceed. Canada is very fortunate in having ample crude oil supplies available in the offshore, in the Arctic, and in the form of heavy oil and oil sands. Major projects provide the potential to allow us to continue to be major producers of crude oil well into the next century.

Most Canadians would only question **when** these resources will be developed, not **whether**. Failure to develop them today doesn't preclude ultimate development; it just means they won't be developed until after the supply crunch has already occurred. The alternative of encouraging some major crude oil developments sooner rather than later, means that we will be able to capitalize on future energy shortages rather than be victims of them. In addition, we would have the skilled labor and industrial infrastructure in place to allow us to be leaders in responding to new opportunities in Canada and abroad.

Despite the attractiveness of a secure source of crude oil to Canada's economic future and however attractive an active petroleum industry may be in providing an immediate stimulus to the Canadian economy, the investments required to achieve this future are not going to happen under the financial circumstances now facing the petroleum industry. Some impetus is required, not only to make these investments more attractive, but more importantly, to attract the financial resources necessary to fund this investment.

IV. TAX MECHANISMS THAT ATTRACT EQUITY

In seeking a mechanism that would stimulate incremental investment and attract new equity into the petroleum industry, the Government of Alberta has examined a number of references. The history of petroleum taxation in Canada, the tax treatment of other industries, and of frontier exploratory drilling in Canada have all been useful benchmarks. The petroleum industry in the U.S., both before and after recent tax reform measures, also provides some insight. The recommendations outlined below center around earned depletion. In maximizing the effectiveness of this measure, some complementary measures are recommended. Finally, some additional tax measures which are not related to depletion are proposed.

A. Earned Depletion

The Government of Alberta believes reinstatement of earned depletion is the key measure needed to help restore a healthy petroleum industry. Earned depletion is currently available to the mining industry, and its restoration would put the petroleum industry back on the same footing. The Alberta Provincial Treasurer in letters to the Minister of Finance in November, 1986 and January, 1987, advocated this change. It has also has been proposed by the industry associations in recent meetings with energy and finance officials and in submissions to the federal Minister of Finance. Earned depletion offers advantages to the industry, in the first instance, in the form of:

i) increased tax write-offs, which result in increased internal cashflow, and
ii) more attractive project economics

A major attraction though, is:

iii) its ability to attract external funding to the industry.

The vehicle for achieving this is flow through shares, whereby the attractive write-offs associated with earned depletion are flowed through to the new investor. The critical significance of this is that new equity is attracted to the industry at a time when traditional sources of equity cannot be tapped. It is the earned depletion which lowers the risk sufficiently to the purchaser of flow through shares to make them attractive, even under the general economic environment facing the petroleum industry today.

By flowing through the tax write-offs, companies do not have to be taxable to take advantage of earned depletion. It is available to all companies in the industry regardless of their tax status. Also, the equity obtained via flow through shares is typically obtained from a distinct market, primarily retail (individuals), rather than institutional investors. Thus this vehicle does not compete that directly with companies that may seek to tap traditional equity sources, if they choose to or if the market improves. The ability to obtain equity using flow through shares is amply demonstrated by the experience of the mining industry.

In adopting earned depletion, there are some additional complementary tax changes that would be necessary or desirable in making this measure as effective as possible.

- The ability to write-off earned depletion against any type of income, with no limitation on the proportion of such income that can be written-off. This is critical to the marketability of flow-through shares outside the resource sector.

- o 60-day look back: The ability to write-off expenditures incurred within 60 days of the end of a taxation year against taxable income from that previous year. This will enhance the marketability of the flow-through shares.

- o 100% write-off of CDE: This will broaden the attractiveness of earned depletion and the basis on which equity can be raised.

Earned depletion has tremendous potential for the stimulation of petroleum investment, and the cost of it is borne by both levels of government through their respective income tax systems.

B. Taxation of Provincial Incentives

It is extremely troublesome to Alberta that aid provided to industry by a Province is taxed by the federal government. Even where the aid is clearly of the nature of a temporary remedy to a distressed industry the federal government has not been willing to forego taxation of provincial assistance measures. Continuation of this policy is not justifiable and Alberta believes changes to the Income Tax Act to overcome this defect must be a priority issue.

C. Other Tax Changes

Income Streaming

The Government of Alberta requests relaxation of the income streaming provisions in the tax act in order to render more effective the work of the Alberta Small Producer Assistance Commission. It is proposed that the Small Producer Assistance Commissioner have an agreement with Revenue Canada that would allow relaxation of the rules that require separate streaming of income and expenses from preceding corporations within a successor corporation. This would not be a general change in tax policy, but would only apply in those situations proposed by the Commissioner for revitalizing particular companies through mergers and acquisitions. The mandate of the Small Producer Assistance Commissioner is to help small independent Canadian petroleum companies survive where it may be shown that with re-structuring and short-term assistance from creditors and government the company can be viable in the long run. Comparable flexibility in Alberta provincial royalty and tax measures will be granted.

General

Various parties have advocated the changes outlined below as measures to assist the petroleum industry. Alberta supports these changes but does not view them as being as critical as the earned depletion and taxation of provincial incentives issues.

- Canadian Oil and Gas Property Expense (COGPE). It is recommended that one of two alternatives of roughly equivalent value be implemented:

  i) 30% declining balance write-off. This is essentially reinstating the pre-1980 tax treatment of land acquisition; or

  ii) 20% straight-line write-off. This is currently being proposed by IPAC and is based upon mineral leases normally having a 5-year term.

  The current low write-off of Canadian Oil & Gas Property Expense is viewed by the provinces as a measure that was imposed punitively by the federal government, and is inappropriate with respect to provincial land tenure systems and the approach to other depreciation allowances.

- Mandatory Canadian exploration expense deduction. It is proposed that the CEE deduction be made discretionary, like other deductions. The problem with having CEE as a mandatory deduction is that companies may be forced into a position of having to forego utilization of other losses or benefits (such as non-capital loss carry-forwards, or ITC's) which have expiry dates.

V. BENEFITS AND COSTS OF TAX PROPOSALS

A. Impact of Tax Changes on Oil Play Economics

Current low levels of oil and gas investment in Canada are not indicative of a lack of good play prospects. Recent changes to the Alberta royalty and incentive system have resulted in a dramatic improvement in the expected return on investment for some of Alberta's typical oil plays. Table 1, on the next page, presents the impact of the proposed tax changes on four of Alberta's more representative oil plays.

Prior to Alberta's royalty and incentive changes, the West Central Alberta Cretaceous Sands play was marginal at best. Potential investors could expect a return from 7.6% - 9.4% depending on their tax status. This was not sufficient allure for investment dollars with current industry hurdle rates running between 10% and 15%. Under the existing regime, this investment propect has improved by over 88% to between 14.4% and 17.7%. However, without sufficient internal cashflow or a tax system that will attract new equity to this market, prospects such as this are now sitting idle.

Table 1

ALBERTA OIL PLAY ANALYSIS
Impact of Tax Changes
on
Return on Investment

	W.C. Alberta Cretaceous Sands	N.W. Alberta Devonian Reef	W.C. Alberta Devonian Reef	N.W. Alberta Non-Reefal Carbonate
A. Full Flow Through Taxes (1)				
1. Prior to Alta Royalty Changes (3)	9.4%	13.1%	12.9%	13.3%
2. Existing Regime	17.7%	24.7%	24.4%	25.2%
3. Earned Depletion on CDE & CEE (4)	24.3%	33.5%	34.7%	31.0%
4. CDE @ 100% (4)	19.5%	25.2%	24.6%	27.0%
B. Project Limited Taxes (2)				
1. Prior to Alta Royalty Changes (3)	7.6%	10.0%	9.4%	11.2%
2. Existing Regime	14.4%	18.8%	17.8%	21.2%
3. Earned Depletion on CDE & CEE (4)	15.2%	19.6%	18.6%	22.0%
4. CDE @ 100% (4)	14.6%	18.8%	17.8%	21.5%

Notes:
1. Tax writeoffs able to be used outside of project.
2. Tax writeoffs restricted to project.
3. New Royalty regime introduced Nov.1, 1986: Reduced roy rates, 5 yr. royalty holiday
4. CDE write-off is currently 30% on declining balance.
5. Assumes $15US/bbl price case.

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With the introduction of earned depletion the cashflow problem is reduced. Project returns on West Central Alberta Cretaceous Sands plays improve significantly for a fully taxable firm and marginally for a nontaxable company. However, with the use of flow through shares, the attractive writeoffs offered by earned depletion can be passed on to potential new investors. This influx of new equity into the market will then allow these oil plays to proceed.

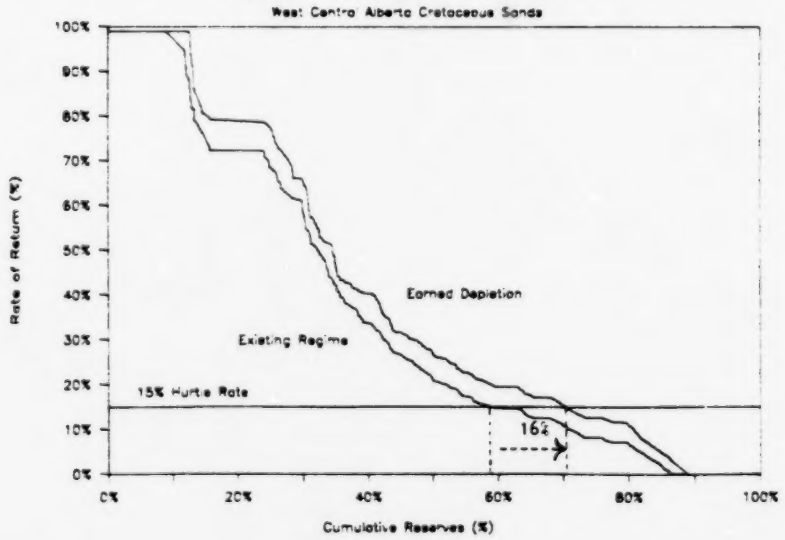
Similar conclusions can be drawn for the other Devonian Reef and Non-Reefal Carbonate plays that are shown in table 1.

B. Impact of Tax Changes on Reserve Additions

The introduction of the tax changes proposed will have a significant impact on investment and activity in the Canadian oilpatch. In addition, there is a great potential to make substantial gains in reserve additions. Preliminary results from a consultant's study[1] indicate that a 16% increase in reserve additions may be possible with the introduction of earned depletion. Figure 2, below, shows that for any hurdle rate of return[2], reserve additions will be greater under a regime with earned depletion vis a vis the existing tax system. Similar results have also been seen in the other Alberta oil plays in the study that is now being finalized.

Figure 2

ALBERTA PLAY ANALYSIS



1. Commissioned by Alberta Department of Energy.
2. Industry suggests that a 15% nominal return is currently required for projects to proceed.

This research suggests that the implementation of earned depletion, in concert with the other changes, could increase our reserve base and address some of our short term concerns with security of supply. These prospects are economical to develop. What we need now is a tax system that will encourage outside investment to venture into this market.

C. Estimate of Taxes Foregone

The introduction of the tax changes proposed will have an impact on government treasuries. Initially the increased writeoffs will result in a reduction in corporate income tax. However, this reduction will be recovered in future years owing to the increase in taxes on income that is derived from incremental investment. The important point here is that the incremental investment will not occur without changes to the tax system that will attract new equity to the oil industry.

Table 2 gives an estimate of the cost of foregone tax revenue for 1987. The proposed tax changes are estimated to result in approximately $150 million less being paid in corporate taxes in 1987. This is estimated to encourage $600 million in new investment. The $150 million cost will be partially offset by the expected reductions in UIC benefits and the increase in personal income taxes that result from the employment spinoffs of this new investment.

D. Impact of Tax Changes on Employment

The incremental investment of $600 million which can occur as a consequence of the tax changes will reduce unemployment in the country. Based on IPAC analyses of employment multipliers, one can expect an additional 4,900 direct jobs as a result of the incremental investment, plus 6,300 indirect jobs. Total additional jobs which could be created are 11,200.

Table 2
1987
ESTIMATE OF TAXES FOREGONE
($Million)

		$Million
Base Investment		2,883
Incremental Investment due to New Incentives		600
Total Investment		3,483
Write-offs:	Existing Regime	983
	Proposed Regime	1,294
	Incremental	311
Federal Tax Reduction	36.57%	114
Provincial Tax Reduction	11.00%	34
Total Foregone Taxes (1)		$148

Note:
1. Ignores additional taxes collected in future due to incremental investment and resultant reductions in UIC benefits and higher personal incomes.

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